No. 94

In the Supreme Court of the United States

OCTOBER TERM, 1944

FRED T. HOGAN, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

INDEX

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OPINIONS BELOW

The opinion of the Tax Court (R. 82–93) is not officially reported. The opinion of the circuit court of appeals (R. 120–126) is reported in 141 F. 2d 92.

JURISDICTION

The judgment of the circuit court of appeals was entered on February 25, 1944 (R. 126–127). Petition for a writ of certiorari was filed May 23, 1944. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether a transfer in 1938 of an interest in a producing oil and gas leasehold together with the equipment thereon, for a cash consideration and the retention of an overriding royalty, was a sublease resulting in ordinary income under Section 22 (a) of the Revenue Act of 1938, as the Commissioner contends, or a sale giving rise to capital gain under Section 117 of the Act, as the petitioner contends.

STATUTE AND REGULATIONS INVOLVED

The pertinent sections of the statute and regulations are set forth in the Appendix, *infra*, pp. 11–13.

STATEMENT

The material facts as found by the Tax Court (R. 83–91) may be stated as follows:

In 1936, petitioner and L. H. Choate acquired an interest in the "Baker lease," consisting of the oil, gas, and casinghead gas, and rights thereto, at and above a certain depth from the surface in and under 230 acres of land in Upton County, Texas. The lease was subject to a 1/8th royalty interest retained by the original lessor, an overriding royalty in Continental Oil Company of 1/16th of all oil, gas, or casinghead gas produced, saved, and sold from depths not exceeding a certain depth from the surface, and $2,500 payable to the immediate assignor out of 1/8th of 13/16ths of all oil produced and saved from the property if, as, and when produced. (R. 83–84.)

In acquiring the interest in the Baker lease, petitioner and L. H. Choate were acting for themselves and for W. G. Choate. These parties then organized a partnership known as Choate & Hogan, of Midland, Texas, to own, develop, and operate the interest in the Baker lease. The partnership drilled six wells on the lease. (R. 84–85.)

On August 11, 1938, the partnership entered into a written contract covering the Baker lease with the McAlester Fuel Company, in which the partnership was designated as "seller" and the McAlester Fuel Company as "buyer." Under the contract the partnership was to execute and deliver an assignment of the lease to the McAlester Fuel Company, for a consideration of $110,000 in cash. The partnership was "to except and reserve to themselves, their heirs and assigns, an overriding royalty of 1/8th of 8/8ths of all oil and gas produced" by the McAlester Fuel Company, its successors, or assigns. By agreement between the parties the contract of purchase of the lease was to be carried out by execution of an instrument of conveyance to the Sylva Oil Company, instead of to the McAlester Fuel Company. (R. 86.)

On August 22, 1938, the Sylva Oil Company notified L. H. Choate that it had purchased the lease, "together with the producing oil wells thereon and the equipment of such wells, including the house on the lease" (R. 86). On the same

date Choate and petitioner executed an instrument (R. 86–87) by which they did "bargain, sell, assign and convey," subject to all the terms of the instrument under which it was acquired by the partnership, all of the partnership's right, title and interest in the property.

> together with all wells and the equipment thereof, including pumps, casing, piping, tanks, lease house, and all other personal property on or used in connection with said premises, including oil in storage, to Sylva Oil Company, a Texas corporation, its successors and assigns; save and except that assignor herein expressly reserve to themselves, their heirs and assigns, and do not assign or convey to the assignee herein, 1/8th of the 8/8ths of all oil and gas and casinghead gas which may be produced and saved by Sylva Oil Company its successors and assigns, from the aforesaid land at and above the depth of two thousand seven hundred fifty feet from the surface under and by virtue of the lease above mentioned, delivery of such part of the oil, gas and casinghead gas to be made free of cost to the assignors * * *; such reservation of overriding royalty or share of production to be 1/16th of the 8/8ths in favor of L. H. Choate, and 1/16th of the 8/8ths in favor of Fred T. Hogan.

At the date of the transaction with Sylva Oil Company the interest in the Baker lease owned by Choate and petitioner consisted of 13/16ths of

8/8ths, the $2,500 oil payment having been paid out during March 1938. The cost, less depletion sustained, of this interest to the partnership was $23,583.78 on that date. (R. 87.)

After the assignment Sylva Oil Company drilled and paid for four additional oil wells and operated the lease, and the parties otherwise conformed to the terms of the instrument. Neither the Choates nor petitioner understood that they had any rights as landlord. Sylva Oil Company certified and guaranteed to Humble Oil Company that effective 7:00 A. M. on August 15, 1938 (the effective date of the last transaction) it was the legal owner of a 7/8ths interest in the oil produced from the property covered by the Baker lease, subject to overriding royalties of 1/16th each to Continental Oil Company, L. H. Choate, and petitioner. (R. 87–88.)

The transaction involved was reported in the partnership return of Choate & Hogan for the year 1938 as a sale, as follows (R. 88–89):

	Leasehold	Equipment	Total
Sale Price	$98,454.70	$11,545.30	$110,000.00
Less Cost of Sale:			
Gross Cost	33,391.80	30,206.49	63,598.29
Less—Reserves for Depletion and Depreciation	9,808.02	7,115.89	16,923.91
Net Cost of Sale	23,583.78	23,090.60	46,674.38
Gross Gain from Sale	74,870.92	(11,545.30)	63,325.62
Less Commission Paid	3,000.00		3,000.00
Net Gain from Sale	71,870.92	(11,545.30)	60,325.62
Taxable Gain from Sale (Sec. 117, Revenue Act of 1938)	$47,913.95	($11,545.30)	$36,368.65

The loss of $11,545.30 as computed on the sale of equipment was reported as an ordinary loss. The net gain from the sale of the leasehold of $71,870.92 was reported as a long-term capital gain under Section 117 of the Revenue Act of 1938 (Appendix, *infra*), taxable to the extent of $47,913.95. The above gain and loss were reported in the individual returns of the partners in accordance with their partnership interests. (R. 89.)

In his notice of deficiency the Commissioner determined that the partnership did not make a sale of the Baker lease but held that the transaction constituted a sublease, the initial cash payment of $110,000 being a bonus. The Commissioner computed the gain on the transaction as follows (R. 89):

Oil income		$110,000.00
Less:		
Depletion	$30,250.00	
Commissions	3,000.00	33,250.00
		$76,750.00

The Tax Court held with the Commissioner that the transfer by the partnership of its interests in the lease was a sublease and not a sale, and that the partnership must recover its capital investment therein through depletion allowances. With respect to the equipment, however, the Tax Court followed the view of the petitioner, and held that the unrecovered cost of the equipment could be deducted from the cash consideration received. (R. 91–92.) The circuit court of appeals affirmed

the Tax Court on both of these issues (R. 124–126).

ARGUMENT

There is no occasion for further review of this case. The issue which petitioner seeks to have redetermined here was decided below upon uniformly accepted principles of law established long since by this Court and by it frequently reiterated.[1] And the asserted "conflict" which is claimed (Pet. 5) as an *inter alia* basis for issuance of the writ does not relate to any matter which was decided below adversely to the petitioner: it concerns only the holding of the courts below with respect to the deductibility of the cost of the equipment—an issue which was decided in petitioner's favor.

There can be no question but that the assignment by the partnership of a part of its leasehold interest for a cash bonus and an overriding royalty resulted in a sublease rather than a sale, and that the partnership could look only to depletion allowances for the return of its capital. The decision of this Court in *Burnet* v. *Harmel,* 287 U. S. 103, a case on all fours with the one at bar, furnishes a complete answer to petitioner's every contention. There, as here, under an instrument providing for overriding royalties with cash

[1] *Burnet* v. *Harmel*, 287 U. S. 103; *Palmer* v. *Bender*, 287 U. S. 551; *Murphy Oil Co.* v. *Burnet*, 287 U. S. 299. See also *Thomas* v. *Perkins*, 301 U. S. 655. And compare *Anderson* v. *Helvering*, 310 U. S. 404.

bonus, the taxpayer recipient sought to have the bonus taxed as gain from the sale of a capital asset rather than as ordinary income subject to depletion allowances. But this Court, decisively rejecting the contention, declared in the *Harmel* case (p. 107) that such transactions are not "sales" of the mineral content of the soil. And this was true, the Court said (p. 109), even though under the law of Texas (the situs both of the *Harmel* well and of the one involved in the case at bar) an oil and gas lease operates instanter to pass to the lessee title to the oil and gas in place. The state law creates legal interests, but the federal statute determines when and how they shall be taxed; and for such purpose the economic consequences of the lease must be considered rather than any particular characterization of the payments in local law. Where the instrument reserves in the lessor the right to share in the oil as produced, there is no conversion of capital as upon the sale of a capital asset. By virtue of the provision for overriding royalties, on which the cash bonus is considered an advance,[2] the lessor retains an economic interest in the gas and oil in place; hence payments representing his share in production are ordinary income to him and he recoups his capital investment through depletion allowances. The situation is fundamentally the

[2] See Article 23 (m)–10 of Treasury Regulations 101, promulgated under the Revenue Act of 1938 (Appendix, *infra*); *Murphy Oil Co.* v. *Burnet*, 287 U. S. 299.

same as that of a land owner who conducts mining operations upon his own property, and the tax consequences are fundamentally alike. Such is the doctrine of the *Harmel* case; and that doctrine is clearly appropriate to and fully dispositive of this case.[3] The court below correctly so held.

The taxpayer in the *Harmel* case made the same argument with respect to the "relief" purpose of the capital gains provisions as does the taxpayer at bar. But again, as this Court pointed out in the *Harmel* case (p. 106), a transaction of this kind does not call for the "relief" which Congress intended thus to provide. Abstraction of gas and oil is a time-consuming operation, and the payments to the assignor do not normally become payable as the result of a single transaction within the taxable year as in the case of a sale of property; no favored tax treatment is accordingly warranted.[4]

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[3] As in the *Harmel* case, we are here dealing with a true overriding royalty as distinguished from an oil payment transaction. Hence, there is manifestly no need to consider any of the problems raised by petitioner (Pet. 6, *et seq.*) as to whether the Circuit Courts of Appeals for the Fifth and Tenth Circuits have held a sale to result where the retained interest is an oil payment rather than an overriding royalty, whether there is any efficacy to such a distinction, and what is the present decisional status thereof.

[4] Nor is there any merit to petitioner's claim (Pet. 9) that the decision below is probably in conflict with *Thomas* v. *Perkins*, 301 U. S. 655. The *Perkins* case was concerned with whether that part of the proceeds of production which the assignee paid over to the assignor as oil payments was tax-

CONCLUSION

The petition for certiorari should be denied.
Respectfully submitted.

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JUNE 1944.

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able income to the assignee. The case was decided upon the same basic principles as underlie the decision at bar; the Court there held that since, in the provision for the oil payment, the assignor retained a depletable interest in the oil and gas in place, the proceeds allocable to the retained interest were income to the assignor.

APPENDIX

Revenue Act of 1938, c. 289, 52 Stat. 447:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

* * * * *

(m) *Depletion.*—In case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. * * * In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. * * *

* * * * *

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

* * * * *

(b) *Basis for Depletion.*—

* * * * *

(3) *Percentage Depletion for Oil and Gas Wells.*—In the case of oil and gas wells the allowance for depletion under section 23 (m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23 (m) be less than it would be if computed without reference to this paragraph.

* * * * *

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) *Definitions.*—As used in this title—

(1) *Capital Assets.*—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23 (l);

* * * * *

(b) *Percentage Taken into Account.*—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net income:

100 per centum if the capital asset has been held for not more than 18 months;

66⅔ per centum if the capital asset has been held for more than 18 months but not for more than 24 months;

50 per centum if the capital asset has been held for more than 24 months.

* * * * *

Treasury Regulations 101, promulgated under the Revenue Act of 1938:

ART. 23 (m)–10. *Depletion—Adjustments of accounts based on bonus or advanced royalty.*—

* * * * *

(*d*) In lieu of the treatment provided for in the above paragraphs the lessor of oil and gas wells may take as a depletion deduction in respect of any bonus or advanced royalty from the property for the taxable year 27½ percent of the amount thereof; * * * but the deduction shall not in any case exceed 50 percent of the net income of the taxpayer (computed without allowance for depletion) from the property.

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